IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1945

No. 966

HERBERT L. STERN,

Petitioner,

vs.

CARTER H. HARRISON, Collector of Internal Revenue,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Herbert L. Stern, by A. J. Pflaum, Harry N. Wyatt, Richard H. Levin and Hedwig F. Brann, his counsel, prays that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit in this case.

STATEMENT OF MATTER INVOLVED.

During 1935 and 1936 Balaban & Katz Corporation (hereinafter for convenience sometimes referred to as "B & K"), a corporation engaged in the operation of motion picture theatres in Chicago, adopted a plan for refinancing or recapitalization, designed to substitute low interest

bank loans for high yield securities (notes and preferred stock), thereby diminishing its annual charges before common dividends. During 1936, as one step in the carrying out of this plan, B & K acquired by redemption approximately 50% of its outstanding preferred stock. The petitioner, who was a preferred stockholder of B & K at that time, realized a gain of $22,650.16 upon this disposition of his stock and treated this gain in his 1936 income tax return as a capital gain subject to the percentage limitations of Section 117(a) of the Revenue Act of 1936. (This statutory provision and the other pertinent statutory provisions here involved are quoted in full in the Appendix hereto.)

This treatment was contested by the Commissioner of Internal Revenue on the theory that the payment by B & K for preferred stock in 1936 was governed by Section 115(c) of the Revenue Act of 1936 as "amounts distributed in partial liquidation of a corporation" and hence the gain on such payment was 100% taxable. The petitioner paid the deficiency claimed and proceeded in the regular form to seek a refund of the amount so paid.

The District Court held that the sale of the preferred stock was one step in and could not be dissociated from the plan of refinancing or recapitalization, that there was no distribution in partial liquidation of B & K within the meaning of Section 115(c) and that the gain was subject to the percentage limitations of Section 117(a).

On appeal by the respondent, the Circuit Court of Appeals for the Seventh Circuit held that the findings of the District Court were subject to review, that the transaction was a distribution in partial liquidation of the corporation within the meaning of Section 115(c) and that the gain was 100% taxable.

JURISDICTION.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, § 1, 43 Stat. 938; 28 U.S.C.A. § 347(a). The judgment herein sought to be reviewed is a decision of the United States Circuit Court of Appeals for the Seventh Circuit entered December 18, 1945 (R. 132).

QUESTIONS PRESENTED.

1. Was the finding of the District Court, that the sale of preferred stock here involved was one step in and could not be dissociated from the plan of refinancing and recapitalization of B & K and hence that payment for said stock was not a distribution in partial liquidation, subject to review by the Circuit Court of Appeals?

2. Were the amounts received by the petitioner on the sale of his B & K preferred stock in 1936 "amounts distributed in partial liquidation of a corporation" within Section 115(c) of the Revenue Act of 1936?

REASONS FOR ALLOWANCE OF WRIT.

1. In reviewing and reversing the findings of the District Court herein, the Circuit Court of Appeals has assumed authority which it would not have had, under the applicable decisions of this Court, if the decision of first instance herein had been entered by the Tax Court of the United States.

Dobson v. *Commissioner,* 320 U. S. 489;
John Kelley Company v. *Commissioner,* .... U. S. ...., 90 L. ed. 257.

The question whether the rule of reviewability shall be different for decisions of the Tax Court and decisions of the District Courts involving the same issues is an important question of Federal law which has not been but should be settled by this Court.

2. The decision of the Circuit Court of Appeals that the findings of the District Court herein are reviewable is in conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit to the effect that the rule of *Dobson* v. *Commissioner*, 320 U. S. 489, is applicable on review of decisions of the District Court.

Blumenthal Print Works v. *United States*, 141 F. (2d) 211 (CCA 5th).

3. The decision of the Circuit Court of Appeals that the redemption of stock in the present case was "automatically" a "distribution in partial liquidation of a corporation" as provided in Section 115(c), without reference to the attendant circumstances and without reference to the form, history and intention of the applicable statutory provisions, is in conflict with applicable decisions of this Court to the effect that definitions in the revenue laws must not be read mechanically so as to force the application of the law to transactions never intended to be covered.

Gregory v. *Helvering*, 293 U. S. 465;

Pinellas Ice & Cold Storage Company v. *Commissioner*, 287 U. S. 462;

Guy v. *Donald*, 203 U. S. 399, 406;

Helvering v. *Morgan's, Inc.*, 293 U. S. 121, 126.

4. Said decision of the Circuit Court of Appeals is in conflict with decisions of other Circuit Courts of Appeals in the same matter, to the effect that a redemption or cancellation of stock may not be dissociated from all of the attendant facts and circumstances so as to characterize the

transaction as a distribution in liquidation of a corporation where the transactions taken as a whole are not in substance liquidating.

Commissioner v. *Whitaker*, 101 F. (2d) 640 (CCA 1st);

Commissioner v. *Kolb*, 100 F. (2d) 920 (CCA 9th);

Helvering v. *Schoellkopf*, 100 F. (2d) 415 (CCA 2d);

Helvering v. *Leary*, 93 F. (2d) 826 (CCA 4th);

Gutbro Holding Company v. *Commissioner*, 138 F. (2d) 16 (CCA 2d).

These reasons are further and more fully developed in the brief in support hereof, annexed hereto.

All of which is respectfully submitted.

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BRIEF IN SUPPORT OF PETITION.

Opinion Below.

The opinion of the District Court for the Northern District of Illinois, Eastern Division, is by District Judge Sullivan (R. 90) and reported at 55 F. Supp. 687. The opinion of the Circuit Court of Appeals for the Seventh Circuit is by Circuit Judges Evans, Sparks and Kerner (Judge Sparks writing) (R. 126), and reported at 152 F. (2d) 322.

Statement of Jurisdiction.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, 28 U.S.C.A., § 347, as amended, to review a decision of the United States Circuit Court of Appeals for the Seventh Circuit, entered December 18, 1945 (R. 132).

Statement of the Case.

The petitioner was the holder of preferred stock of B & K, a large motion picture exhibitor, which emerged after the first few years of depression, following the financial collapse of 1929, with about $6,000,000 of publicly-held notes and preferred stock bearing interest of 5½% and 6% and dividends of 7% (R. 25). By 1935 it was well able to obtain substantial bank loans at much lower rates and in that year it adopted and put into effect a plan for replacement of the high charge securities with low charge bank loans. Pursuant to this plan B & K borrowed sufficient money from the bank in 1935 to retire all of its outstanding 5½% and 6% notes, and borrowed fur-

ther amounts from the bank in 1936, with which it redeemed half of its 7% preferred stock. The bank interest rate was 3½% (R. 25-26). The total of loans and preferred stock remained almost constant, that is, it varied from $5,946,100 on December 30, 1933 to $5,876,660.67 on January 1, 1938 (R. 71). The refinancing and recapitalization plans approved by the Board of Directors in 1935 and 1936 showed an aggregate saving to the corporation over a ten-year period of approximately $1,000,000, assuming that the operations of the corporation continued undiminished (R. 40).

The petitioner realized a gain of $22,650.16 on the redemption of his B & K preferred stock in 1936, which would be taxable to the extent of $8,964.55 under the capital gain percentage limitations of Section 117(a) of the Revenue Act of 1936, if applicable, and would be taxable in full under the partial liquidation provisions of Section 115(c) of the Revenue Act of 1936, if applicable (R. 24). The question was raised by a suit for refund in the District Court (R. 2), the petitioner having theretofore paid additional 1936 income tax based upon full taxation of his gain and his claim for refund with respect thereto having been disallowed (R. 24).

The District Court held that the gain was subject to the percentage limitations of Section 117(a) and that the redemption price received by the petitioner did not constitute "amounts distributed in partial liquidation of a corporation" under Section 115(c), based upon its following findings of fact (among others) (R. 107-108):

> "18. The funds used by Balaban & Katz Corporation for the purchase of said preferred stock were obtained by it, pursuant to the plan approved by its directors, from The First National Bank of Chicago under an agreement increasing the bank loan of the

corporation and reducing the interest rate on said loans to 3.125%. The aim of the plan was to replace all of the outstanding obligations and preferred stock of Balaban & Katz Corporation, which aggregated approximately $6,000,000 and bore interest and dividends prior to dividends on the common stock of between 5½% and 7%, with bank loans bearing interest at 3.125%.

"19. The sale of Balaban & Katz Corporation preferred stock by plaintiff during 1936 here involved was one step in, and may not be dissociated from all of the other attendant circumstances and transactions which form a part of, an elaborate plan of refinancing or recapitalization adopted and put into effect by Balaban & Katz Corporation by eliminating notes and preferred stock which bore high rates of interest, and substituting therefor a bank loan or loans carrying a much lower rate of interest, thereby increasing the net income for the payment of dividends on the common stock; the corporate structure was in no wise changed, the total assets or total capitalization were not decreased, no steps taken toward liquidating the business in any way, the only result of the transaction being to increase the net income available for the payment of dividends on the common stock.

"20. The position of Balaban & Katz Corporation as one of the leading motion picture exhibitors in the Chicago area was not changed as a result of the recapitalization plan which was put into effect during 1935 and 1936, nor were its assets, aggregate debt and stock capitalization, or operations reduced in any way by the adoption of the plan; the acquisition of preferred stock did not involve anything like a partial liquidation, nor was it in accordance with any bona fide plan of liquidation within the ordinary meaning of that term; apart from any question of the income tax consequence of the effect upon a statutory provision of the motive or intent of taxpayer or any other person, the transaction here involved viewed in its entirety does not come within the meaning of the term 'amounts distributed in partial liquidation of a corporation' as defined in Section 115(i) of the Revenue

> Act of 1936; the ultimate goal sought to be accomplished by Balaban & Katz Corporation, without giving any consideration to the intent of the parties, was not in reality a partial liquidation of that corporation, but rather amounted to an expansion of the same."

The Circuit Court of Appeals reviewed and reversed the District Court's decision, notwithstanding the foregoing findings, on the ground that the transaction was a cancellation and redemption of preferred stock, "thereby automatically subjecting it to the treatment for tax purposes provided by § 115(c)" (R. 130).

Errors to be Urged.

The Circuit Court of Appeals erred:

1. In holding that the District Court's findings were subject to its review.

2. In holding that the payment received by petitioner from B & K upon the redemption of his preferred stock in pursuance of a refinancing and recapitalization plan of the corporation constituted "amounts distributed in partial liquidation of a corporation" under Section 115(c) of the Revenue Act of 1936, and not proceeds of a sale subject to the percentage limitations of Section 117(a).

ARGUMENT.

In view of the fact that the argument presented in this brief follows directly the outline stated under the heading "Reasons for Allowance of Writ" in the petition immediately preceding the brief, it is deemed unnecessary to present a summary of argument at this point.

1. **The question whether findings of the District Court are subject to more extensive review than findings of the Tax Court should be settled by this Court.**

The only question presented in this case is whether the moneys received by the petitioner on redemption of his B & K stock in 1936 constituted "amounts distributed in partial liquidation of a corporation" under Section 115(c) of the Revenue Act of 1936. Section 115(i) defines the term "amounts distributed in partial liquidation" as "complete cancellation or redemption" of stock. The position of Sections 115(c) and 115(i) in the statutory scheme and the effect of varying factual situations upon the application of these provisions are described in subdivisions 3 and 4 of this brief, showing that the application of these provisions depends upon the infinite variations in the facts from case to case in which the considerations of fact and law are inextricably intertwined. Under these circumstances, if the present case had been tried in the Tax Court of the United States, instead of the District Court, the trial court's findings would not have been subject to review.

Dobson v. *Commissioner*, 320 U. S. 489;
John Kelley Company v. *Commissioner*, ... U. S. ...., 90 L. ed. 257.

In these cases this Court has maintained its insistence

upon the finality of mixed-fact-and-law findings and of ultimate fact findings of the Tax Court with a view toward reducing the overwhelming burden of appellate tax litigation.

The development of judicial recognition of the findings of the Tax Court has been toward increasing the dignity of this tribunal to a stature equal but not superior to that of the District Courts.

At the time of its organization, the Tax Court (then known and hereinafter for convenience sometimes referred to as the Board of Tax Appeals), was an administrative tribunal of relatively little standing (compared to the Federal Courts), whose findings had only evidentiary value and were subject to trial *de novo* in the District Courts. In 1926 the statute was changed so as to eliminate trial *de novo* and limit review to errors of law. The purpose expressed by both House and Senate Committees in connection with this change was as follows (H. Rep. #1, 69th Cong., 1st sess. p. 17; to the same effect S. Rep. #52, 69th Cong., 1st sess., p. 37):

> "*Court review—Questions of fact and law.*—The procedure is made to conform as nearly as may be to the procedure in the case of an original action in a Federal district court. . . . In the view of this Committee the decisions of the Board are judicial and not legislative or administrative determinations."

The same purpose was expressed in the Committee reports to the 1928 Revenue Bill (H. Rep. No. 2, 70th Cong., p. 30):

> "A recent decision by the Circuit Court of Appeals for the Seventh Circuit indicates that there is some disposition to regard the Board of Tax Appeals as an investigative rather than a judicial body, and to require it to reach its decisions not merely on the basis of the evidence presented in the record, but on the

> basis of such additional evidence outside the record as may be necessary fully to develop the taxpayer's case. The committee is of the opinion that the board's function is purely judicial, and in order to clarify the situation has provided that no decision of the board (whether rendered before or after the bill becomes law) should hereafter be modified or reversed because the board or any of its divisions has failed to consider evidence not adduced before the board or division. At the same time the committee has provided that the rules of practice and procedure of the board shall, just as the Federal equity rules, have the force and effect of law."

Pursuant to these committee expressions, the Courts have striven to establish the Tax Court as a judicial body to be accorded the same dignity and standing as any other Federal trial courts. It required litigation for some time to establish the right of the Board of Tax Appeals to enforce its subpoena power (*Blair* v. *Oesterlein*, 17 F. (2d) 663 (App. D. C.), aff'd with modifications, 275 U. S. 220) to establish rules of procedure governing admission to practice (*Goldsmith* v. *U. S. Board of Tax Appeals*, 270 U. S. 117) and to establish that the rule of *res adjudicata* was applicable to Board decisions (*American S. S. Co.* v. *Wickwire Spencer Steel Co.*, 8 F. Supp. 562, 566 (D.C. N.Y.); *Nachod & United States Signal Co.* v. *Helvering*, 74 F. (2d) 164, 166 (CCA 6th); *Greenbaum* v. *United States*, 17 F. Supp. 83 (Ct. Cl.). The Board of Tax Appeals itself expressed its powers in the following language (*Garden City Feeder Co.*, 27 B.T.A. 1132, 1140):

> "the Congress was content that it had established the Board as a legislative (in contradistinction to constitutional) inferior tribunal, having judicial powers within its limited jurisdiction and capable of handing down, not merely administrative determinations, but judicial decisions."

The necessity of emphasizing the dignity bestowed upon the Board of Tax Appeals so as to conform its powers to those of the District Court is indicated by the celebrated opinion of this Court in *Blair* v. *Oesterlein Machine Co.*, 275 U. S. 220, 227:

> "An examination of the sections creating the Board and investing it with power can leave no doubt that they were intended to confer upon it appellate powers which are judicial in character."

Over the years, the courts have analyzed and discussed questions of review of tax cases (whether arising in the District Court or in the Board) in identical terms, regularly giving identical effect to the findings and never raising any question whether a different rule of reviewability might be applicable:

Arising from District Court	Arising from Board of Tax Appeals
McCaughn v. *Real Estate Land Title & Trust Company*, 247 U. S. 606.	*Colorado National Bank of Denver* v. *Commissioner*, 305 U. S. 23.
(Both involving alleged gifts in contemplation of death, and both reversing Circuit Court of Appeals reversals on the ground that the question was one of fact.)	
Guggenheim v. *Rasquin*, 312 U. S. 254.	*Powers* v. *Commissioner*, 312 U. S. 259.
(Both involving rule for gift tax valuation of single premium life insurance, and both affirming Circuit Court of Appeals reversals on the ground that the question was one of law.)	

Arising from District Court	Arising from Board of Tax Appeals
Deputy v. *duPont*, 308 U. S. 488.	*Helvering* v. *Tex-Penn Oil Company*, 300 U. S. 481.

(Both holding that findings of "ultimate fact" are reviewable.)

Marsh v. *Commissioner*, 110 F. (2d) 423 (CCA 7th).

(Involving a question of trade or business similar to that involved in *Deputy* v. *duPont*, 308 U. S. 488, and reversing in express reliance upon rule of reviewability established in that case.)

Exmoor Country Club v. *United States*, 119 F. (2d) 961 (CCA 7th).

(Relied without distinction upon the rules of reviewability stated in *Bogardus* v. *Commissioner*, 302 U. S. 34, arising from Board of Tax Appeals, and *Deputy* v. *duPont*, 308 U. S. 488, arising from District Court.)

Not only the courts but the legal commentators also have emphasized the judicial character of the Board of Tax Appeals:

Griswold, *The Need for a Court of Tax Appeals*, 57 Harv. L. Rev. 1153, 1154, 1170:

". . . the Tax Court is in organization, tradition, and function a judicial body, and should be treated

> as such in any survey of judicial review in tax cases . . . That court is a court in name and in fact, and in everything else except the letter of the statute and the Committee Reports. It acts judicially, and has a fine record in acting judicially. It is not a policy formulating and enforcing agency. It sits impartially between the Commissioner and the taxpayer."

Eisenstein, *Some Iconoclastic Reflections on Tax Administration,* 58 Harv. L. Rev. 477, 541-42:

> ". . . the Tax Court has been and still is a specialized tribunal passing upon controversies in the traditional manner of the judiciary. If the concept of administration includes the authoritative formulation of subsidiary rules by a rule-making agency, the Tax Court is no more administrative in character than a district court."

Stevens, *Legal Evidence before the Board of Tax Appeals,* 6 National Tax Magazine 459, 461:

> ". . . the United States Board of Tax Appeals is not a fact finding body, not a governmental bureau, not another commission, not a board of arbitrators. It is a court."

Thus we find that at the present time, after years of effort on the part of the Congress, the courts (including the Tax Court itself), the Treasury Department, and taxpayers, the Tax Court has been established in a position coordinate and comparable in all respects with the District Courts. In the tax field the problems presented are identical, the manner of presentation is identical, the forms and court procedures are virtually identical, the precedents and rules to be applied are identical, and the goals to be accomplished are substantially identical. As far as the Circuit Courts of Appeals are concerned, the appellate presentation is identical whether arising from the District Court or from the Tax

Court—that is, the issues, parties, records, arguments and precedents appear in identical fashion both as to form and as to substance. Under these circumstances the creation of divergent rules of appellate reviewability would create a critical confusion and ambiguity in the administration of justice in the tax field. This is particularly true because of the essential and unavoidable vagueness and ambiguity to which this Court has repeatedly referred in drawing the fine line between a reviewable finding and a non-reviewable finding. One of the controlling considerations which have moved this Court to adopt the rule enunciated in the *Dobson* and *Kelley* cases is the need for reduction of the disproportionate burden of appellate tax litigation. It is submitted that the volume of such litigation would be increased rather than diminished if the eleven different Courts of Appeals were required to interpret and apply two different sets of principles of appellate review to the same types of cases, presented in the same way but arising out of different trial courts. The inevitable contrast between the points of view expressed by the Circuit Courts of Appeals under two such sets of principles would tend to require the parties to seek review in the Circuit Court of Appeals in every case where the least doubt exists.

Apart from the inequality of making the taxpayer's access to appellate review depend upon whether or not he is financially able to pay the tax claimed and seek refund, the practical effect of such divergent rules would be felt at every step in the administration of the Federal tax law. The taxpayer's natural desire for another day in court, reinforced by the fact that successful refund claims carry interest at six per cent, substantially above the current market interest rate, would tend to divert a substantial and possibly preponderant portion of the tax

litigation to the District Courts and away from the Tax Court, which this Court wishes to establish as the primary tax tribunal. This would nullify to a substantial extent the endeavor of this Court to diminish the volume of tax appeals. The problem has been noted by Mr. Randolph Paul in his article, "Dobson v. Commissioner: The Strange Ways of Law and Fact," 57 Harv. L. Rev. 753, 808:

> ". . . There is no evidence that the drafters of Section 1141(c)(1) contemplated, as the *Dobson* opinion seems to imply, a special set of fact-law concepts to govern petitions to review Tax Court decisions. A question of fact is a question of fact regardless of the trial forum. In emphasizing this facet of review, no aspersions are cast upon either the special administrative procedure devised by Congress or the Tax Court's skill in dissecting tax problems. That court, as previously indicated, was established in order to bring a particularly informed judgment to the solution of tax controversies entangled in 'complicated and technical facts'. But this purpose does not invite any assumption that what is law in the other courts manages to be fact in the Tax Court. Taxpayers are simply given the option of placing their grievances before a specially constituted body or resorting to more traditional channels of relief. Hence, any shifting distinctions between law and fact which depend upon the character of the trial court are exclusively judicial importations, and whether or not they are justified as a matter of policy is entirely irrelevant within the existing statutory framework. In any event, a dual set of competing concepts can only land the circuit courts, as well as the Supreme Court, in a morass of appellate subtleties."

In any event, whether or not this Court intends to apply the *Dobson* rule to findings of the District Court, a critical area of uncertainty remains until the determination is officially made by this Court. Upon taxpayers

and government alike, as well as to the Circuit Courts of Appeals and this Court, a disproportionate weight of appellate tax litigation can be expected to continue so long as the issue remains unsettled. It is a well established rule of this Court that certiorari will be granted where necessary in order to determine questions which affect the efficient administration of the tax laws.

District of Columbia v. *Pace,* 320 U. S. 698, 700.
Dobson v. *Commissioner,* 320 U. S. 489, 492.

2. The decision of the Court below to review the District Court findings is in conflict with the decisions of other Circuit Courts.

The confusion as to the scope of appellate review of District Court findings in tax cases is already creating a conflict in the circuits. In *Blumenthal Print Works* v. *United States,* 141 F. (2d) 211, 212, the Fifth Circuit Court of Appeals specifically relied upon the *Dobson* case in refusing to review the findings of the District Court.

Other Circuit Courts have also taken the position that the findings of the Tax Court are on a parity with findings of the District Courts. In *Commissioner* v. *Liberty Bank & Trust Co.,* 59 F. (2d) 320, 323 (C.C.A. 6th) the Court stated:

> "While it [the Board] is not a court but is an executive or administrative board, it nevertheless exercises 'appellate powers which are judicial in character' . . . In passing upon matters such as are involved in this case, the Board exercises functions similar to those exercised by a trial court in a law case without a jury. *Phillips* v. *Commissioner,* 283 U. S. 589, 599 . . ."

In *Burnet* v. *Lexington Ice & Coal Co.*, 62 F. (2d) 906, 908 (C.C.A. 4th), the Court stated:

> "Although the Supreme Court has indicated that the Board of Tax Appeals is not a court (*Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716), its work is of a judicial character (*Blair* v. *Oesterlein Machine Co.*, 275 U. S. 220), . . . and we are of the opinion that the rule governing appeals from courts should prevail as to appeals from the decision of the Board."

To the contrary, in *Lothair S. Kohnstamm* v. *Pedrick*, 152 F. (2d) ..., 46-1 U.S.T.C. par. 9122 (12/28/45), the Circuit Court of Appeals for the Second Circuit directly reversed a decision of the District Court without remanding, in contrast to its prior decision on substantially identical facts arising from the Tax Court, in which it refused to pass upon the facts and remanded for further action by the Tax Court.

It is respectfully submitted that such examples will multiply in the near future unless the question is settled by this Court.

3. In holding that the definition of partial liquidation was "automatically" applicable under its literal terms without reference to the surrounding facts, the decision below is in apparent conflict with decisions of this Court relating to the construction of definitions in the tax law.

Even without reference to the inconsistency in the application of Section 115(c) by the court below, referred to in the last paragraph of this subdivision, the applicable decisions of this Court clearly require that a definition in the tax law such as that involved in Section 115(i), as applied to Section 115(c), must be interpreted in the

light of the congressional intent and the ordinary understanding of the term defined. The decisions follow the same general principle stated by Mr. Justice Holmes in *Guy* v. *Donald*, 203 U. S. 399, 406:

> "The questions certified very properly go beyond the question of the existence of a partnership. As long as the matter to be considered is debated in artificial terms, there is a danger of being led by a technical definition to apply a certain name, and then to deduce consequences which have no relation to the grounds on which the name was applied."

Almost the precise question of whether to apply a tax definition mechanically was involved in *Gregory* v. *Helvering*, 294 U. S. 465, in which the transaction presented to this Court was clearly and specifically within the literal terms of the definition of "reorganization" in the revenue statute. This Court refused to treat the transaction as a reorganization, on the ground that the transaction was not *in substance* a business reorganization and that literal compliance with the statutory forms was not sufficient.

Similarly, in *Pinellas Ice & Cold Storage Company* v. *Commissioner*, 287 U. S. 462, the transaction in question was in form within the literal terms of the reorganization definition and this Court held that the substance of the definition was not present and the transaction would not be treated as a reorganization.

In *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, 126, this Court was concerned with the term "taxable year", which was specifically defined in the applicable revenue act. In applying this definition, this Court stated the rule of construction as follows:

> "But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, *however precise its language*, cannot be ascertained if it be considered apart from related

> sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part." (italics supplied)

In these cases this Court established the rule that such definitions are not "automatically" applicable without consideration of the surrounding circumstances and their relationship to the scope of the statute and the substantive meaning of the term defined. In regarding itself as bound by the literal terms of the statute, the Circuit Court of Appeals, below, has run counter to the explicit rule of this Court.

It is appropriate to state that the Circuit Court of Appeals' reversal of the District Court, herein, was based upon an erroneous misconception of the binding effect of the statute upon the courts. Under similar circumstances in *Commissioner* v. *Heininger,* 320 U. S. 467, 475, this Court approved the reversal of a Board of Tax Appeals decision even though the same decision would have been affirmed if it had been based upon "an independent exercise of judgment rather than upon a mistaken conviction that denial was required as a matter of law."

As a matter of fact even the literal language of the statute applied herein does not require or, it is submitted, permit the interpretation adopted by the Circuit Court of Appeals. Section 115(c) of the Revenue Act of 1936 specifically limits its application to "amounts distributed in partial liquidation *of a corporation*", the Court below has limited its analysis of the issue presented to the definition of "distributions in partial liquidation" (excluding the words "of a corporation") in Section 115(i). Inasmuch as Section 115(i) defines distributions in partial liquidation generally as meaning in cancellation or redemption of stock and inasmuch as the transaction

herein involved, when plucked out of the integrated plan of which it was a part, was formally a redemption, the Court below held that the 100% taxability prescribed by Section 115(c) for partial liquidations "of a corporation" was "automatically" applicable. The conclusion of the Court below was that a partial liquidation occurs under Section 115(c) wherever stock is redeemed, even though the corporation is not being liquidated in any degree. This appears to be directly inconsistent with the inclusion of the words "of a corporation" in Section 115(c) and the inconsistency is not explained in the opinion of the Court below.

4. In holding that a stock redemption is "automatically" a distribution "in partial liquidation of a corporation," without reference to the surrounding circumstances, the decision below is in conflict with decisions of several other Circuit Courts of Appeals in the same matter.

It is not considered appropriate herein to dwell at length upon the history of the definition of "distributions in partial liquidation" and the subsequent use of that definition for penalty taxation in Section 115(c), so as to show what prompted the District Court to hold that the facts here presented did not involve a distribution "in partial liquidation of a corporation". The purpose of this brief is to show the importance of the questions involved and the conflict between the decision below and applicable decisions of this Court and other Circuit Courts of Appeals so as to indicate the desirability of review by this Court. If the petition for certiorari is granted, petitioner will present to the Court a complete discussion of the legal and factual considerations which impelled the District Court to the decision entered.

Basically the District Court decision was that the

preferred stock redemption here involved was an integral step in an elaborate refinancing or recapitalization plan and could not be viewed separately, as a partial liquidation of the corporation, where the plan as a whole involved no characteristics of retrenchment of corporate business or of distribution of idle corporate assets, and on the contrary relied upon a substitution of one type of securities for another in order to stimulate and expand the corporation. A classical statement of the meaning of partial liquidation is contained in the opinion of the Board of Tax Appeals in *Mabel I. Wilcox*, 43 B.T.A. 931, 939-40, aff'd 137 F. (2d) 136 (C.C.A. 9th):

> "The crux of our question is, as the petitioners submit, whether the distribution made in 1934 was made in partial liquidation of the corporation, so that the amounts distributed should be treated 'as in part or full payment in exchange for the stock' under the provisions of subsection (c) above.
>
> * * * * *
>
> What is meant by the word 'liquidation' as used in subsections (c) and (i) above?
>
> In *W. E. Guild*, 19 B.T.A. 1186, 1202, we said:
>
> > 'The word "liquidation" when applied to a partnership or company has a general meaning, well recognized by textwriters and courts, as the operation of winding up of its affairs by realizing its assets, paying its debts and appropriating the amount of profit or loss. 37 Corpus Juris 1265; *Assets Realization Co.* v. *Howard*, 127 N.Y.S. 798; *Gibson* v. *American Rwy. Express Co.*, 195 Iowa 1126, 193 N. W. 274; *Rohr* v. *Stanton Trust & Savings Bank*, 76 Mont. 248, 245 Pac. 947; *Gilna* v. *Barker*, 78 Mont. 357, 254 Pac. 174; *Lafayette Trust Co.* v. *Beggs*, 213 N. Y. 280, 107 N. E. 644; *in Re Union Bank of Brooklyn*, 161 N. Y. S. 29.'
>
> In *Hellman* v. *Helvering*, 68 Fed. (2d) 763, it was said that:
>
> > '* * * In its generally accepted meaning a dividend in liquidation means an act or an

> operation in winding up the affairs of a firm or corporation, a settling with its debtors and creditors, and an appropriation and distribution to its stockholders ratably of the amount of profit and loss. * * *'
>
> See also *Rheinstrom* v. *Conner,* 33 Fed. Supp. 917; *Northwest Bancorporation* v. *Commissioner,* 88 Fed. (2d) 293. In *Tate* v. *Commissioner,* 97 Fed. (2d) 658, it was said that: 'Whether a dividend is a "distribution in liquidation" is a question of fact, and depends upon the intent of the directors of the corporation.' "

A recent careful statement of what partial liquidation is intended to mean in the statute was made by the Court of Claims in the case of *Trust Company of Georgia* v. *United States,* 60 F. Supp. 470, 479:

> "One form in which earnings might be distributed in lieu of a dividend is by partial liquidation of the corporation, as in a case where the corporation has accumulated more assets than it needs to carry on its business, or where it wishes to curtail its activities."

The respondent has relied throughout these proceedings upon certain opinions of the Board of Tax Appeals and the courts indicating that a partial liquidation of a corporation may occur without a direct reduction of the corporation's volume of business. These cases fall into one of two classes, namely, (a) those cases in which the distribution was alleged to have been an ordinary dividend and the discussion in the opinion was directed toward the distinction between capital distributions (typified by a partial liquidation) and ordinary distributions of profits; the holdings in such cases were merely that the absence of a reduction in business volume did not necessarily characterize the distribution as an ordinary dividend; (b) those cases in which the liquidation

was with respect to idle corporate assets not needed in the business, in which the courts have held that the corporation liquidated part of itself by disposing of the idle assets even though the regular business volume was not affected.

None of these cases has any pertinence to a case in which a capital exchange, though cast in the form of a redemption, is merely one step in an integrated series of transactions which neither reduced the corporate business nor disposed of idle corporate assets. All of the courts to which the question has been presented have held that a stock cancellation or redemption may not be characterized as a partial liquidation where the surrounding facts (as determined by the appropriate trier of facts) show an integrated plan which is not a plan of liquidation.

Commissioner v. *Whitaker*, 101 F. (2d) 640 (CCA 1st).

Commissioner v. *Kolb*, 100 F. (2d) 920 (CCA 9th).

Helvering v. *Schoellkopf*, 100 F. (2d) 415 (CCA 2d).

Helvering v. *Leary*, 93 F. (2d) 826 (CCA 4th).

Gutbro Holding Company v. *Commissioner*, 138 F. (2d) 16 (CCA 2d).

All of the foregoing decisions have emphasized that the characterization of a stock redemption as a partial liquidation or not a partial liquidation is a question of fact to be answered by close scrutiny of the attendant circumstances by the trial court. The same position was adopted in approval of the District Court decision herein by another District Court in the case of *Harter Bank & Trust Co.* v. *Gentsch*, 60 F. Supp. 400, 401 (D. C. Ohio).

The decision of the Circuit Court of Appeals herein is the first decision in which the automatic interpretation

of the definition of partial liquidation has been upheld by a Circuit Court of Appeals by plucking a redemption out of its context. The decision below introduces a new element of uncertainty and conflict between the circuits as to the tax effects of integrated recapitalization and refinancing plans, which should be resolved by appropriate decision of this Court.

All of which is respectfully submitted.

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APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 115. DISTRIBUTION BY CORPORATIONS.

* * * * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117(a), 100 per centum of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in par-

tial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

• • • • •

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 966

HERBERT L. STERN, PETITIONER

v.

CARTER H. HARRISON, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 90–102) is reported at 55 F. Supp. 687. The opinion of the Circuit Court of Appeals (R. 126–131) is reported at 152 F. 2d 321.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 18, 1945. (R. 132.)

The petition for a writ of certiorari was filed on March 18, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, as the lower court held, the gain realized by taxpayer on the redemption of his shares of preferred stock in Balaban & Katz Corporation, pursuant to a plan for complete redemption and cancellation of one half of the preferred stock of the corporation, was a distribution in "partial liquidation" as defined in Section 115 (i) of the Revenue Act of 1936 and hence taxable in its entirety under Section 115 (c) of the Act; or whether, as taxpayer contends, the gain was taxable as a capital gain upon the sale and exchange of a capital asset subject to the limitations contained in Section 117 (a) of the Revenue Act of 1936.

STATUTES AND OTHER AUTHORITIES INVOLVED

The applicable statutes and other authorities are printed in the Appendix, *infra,* pp. 24–28.

STATEMENT

The facts were stipulated (R. 23–86) and may be summarized as follows:

Balaban & Katz Corporation (hereinafter referred to as "B & K") was incorporated in 1923 under the laws of the State of Delaware. As of

December 29, 1934, its outstanding capitalization consisted of the following[1] (R. 25):

264,206 shares of common stock of a stated value of	$6,605,150
26,126 shares of 7% cumulative preferred stock par value $100 a share, redeemable at $110 plus accumulated dividends—par value	2,612,600
Serial 5½% gold notes in the principal amount of	2,924,500
Serial 6% gold notes in the principal amount of	128,000

At this time B & K had no substantial bank obligation. (R. 25.)

On May 1, 1935, all of the 5½% and 6% serial gold notes were retired with funds obtained from a bank loan of $2,400,000 bearing interest at 3¼%, plus current funds of B & K, including those held in reserve for serial retirement of the notes. (R. 25.)

Thereafter B & K negotiated with the same bank for an additional loan with a view toward replacing some or all of its outstanding 7% preferred stock with the proceeds of such loan which would bear interest at a rate less than the preferred dividend rate of 7%. (R. 25).

B & K's certificate of incorporation provided that the 7% preferred stock was subject to redemption at any time at $110 per share and all accrued dividends, or by corporate purchase at less than the redemption price. (R. 80.) The certificate also provided that (R. 80)—

---

[1] B & K was authorized to issue 270,000 shares of common stock (par value $25 per share) and 28,700 shares of preferred stock. (R. 79.)

> Preferred stock retired, redeemed or purchased, as herein provided, shall not be reissued, and no preferred stock shall be issued in lieu thereof or in exchange therefor.

At a meeting of the Board of Directors of B & K held on February 5, 1936, a "plan for the redemption and retirement of the outstanding shares of preferred stock" was presented and adopted (R. 25, 28–29); and it was resolved to increase and consolidate the bank loans to an amount not in excess of $3,300,000 with interest not in excess of 3⅛% (R. 29); to give notice for redemption and retirement of one-half of the preferred stock, such redemption to be in accordance with the terms of the charter and by-laws; to withdraw the preferred stock from the list of the Chicago Stock Exchange; and to acquaint the preferred stockholders with the intention of the corporation to redeem and retire all of its preferred stock over a period of years, as set forth in the plan of redemption and retirement (R. 30).

Pursuant to this resolution the outstanding bank loan was increased by $1,373,500 to $3,300,000, bearing interest at 3⅛% (R. 26), the principal being payable within five years from the date thereof, May 1, 1936 (R. 58). In accordance with the plan for redemption and retirement of preferred shares, B & K gave "Notice of Redemption of Preferred Stock" on March 1, 1936, to the preferred stockholders, advising that one-half of

the holdings of each of record on April 3, 1936, would be called for redemption on May 1, 1936, in accordance with the certificate of incorporation, by the payment of $110 per share and accrued dividends. (R. 26, 64–67.) The form "Letter of Transmittal" recited that the preferred stockholder delivered his certificates to the corporation "for redemption" and requested that a check be issued "for the redemption price of the shares to be redeemed on May 1, 1936, and accrued and unpaid dividends thereon to May 1, 1936" and a certificate be issued to him for the number of shares deposited and "not redeemed on May 1, 1936"[2] (R. 68–69.)

Pursuant to this notice to preferred stockholders B & K acquired 12,995 shares of its outstanding preferred stock, leaving 13,061 shares outstanding. (R. 26.) At this time its earned surplus was in excess of $3,000,000. (R. 70, 71.)

On April 28, 1937, a "Certificate of Retirement of preferred stock of Balaban and Katz Corporation," dated February 16, 1937, was filed,

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[2] By corporate resolution the transfer agent was directed, in connection with the issuance of certificates evidencing that portion of preferred shares not redeemed, to stamp upon each certificate (R. 48):

"The Shares of Stock Evidenced by This Certificate Are Not Subject to Nor Entitled to the Benefit of the Redemption Effective and Applicable to One-Half (½) of the Preferred Stock of Balaban & Katz Corporation Which Was Outstanding on May 1, 1936."

as certified by the Secretary of State of Delaware, providing in part (R. 26–27)—

> First: That, pursuant to the provisions of Section 27 of the General Corporation Law of the State of Delaware, as amended, and subject to the provisions of its Certificate of Incorporation, the corporation has, by resolution of its board of directors, retired Thirteen Thousand Fifty-five (13,055) shares of its issued and outstanding Preferred Stock of the par value of One Hundred Dollars ($100.00) per share, heretofore purchased by it out of its surplus.
>
> Second: That the capital of the corporation is hereby reduced by the amount of capital represented by the shares so purchased and retired, to-wit: One Million, Three Hundred Five Thousand, Five Hundred Dollars ($1,305,500.00).
>
> Third: That the Certificate of Incorporation of the corporation prohibits the reissue of said shares when so purchased and retired; and accordingly, pursuant to the provisions of said Section 27, upon the filing and recording of this certificate as therein provided, the Certificate of Incorporation of the corporation shall be amended so as to effect a reduction in the authorized Preferred Stock of the corporation to the extent of One Million, Three Hundred Five Thousand, Five Hundred Dollars ($1,305,000), being the aggregate par value of said Thirteen Thousand Fifty-

five (13,055) shares of such stock so purchased and retired.

Among the preferred shares redeemed by B & K in 1936 were 561 shares transferred by the taxpayer, which shares had a total cost to him for income tax purposes of $39,059.84 The taxpayer received from the corporation for this stock the amount of $61,710, yielding a profit to him of $22,650.16. (R. 24.) In his income tax return for 1936, taxpayer reported this amount as a capital gain realized upon the sale or exchange of a capital asset, but treated only $8,964.55 as includible in income under Section 117 (a) of the Revenue Act of 1936. (R. 24.) The Commissioner determined that the profit of $22,650.16 was taxable in its entirety as a distribution in partial liquidation under the provisions of Section 115 (c) and (i) of the Revenue Act of 1936, resulting in a deficiency in taxpayer's income tax for 1936 of $8,485.08. (R. 24.)

Taxpayer paid the deficiency, with interest thereon, on January 19, 1938, and on June 27, 1938, filed claim for refund of $8,485.08, plus interest of $342.40, total $8,856.57. On July 18, 1940, the Commissioner notified taxpayer of his disallowance of the claim for refund. The present suit was instituted on June 30, 1942. (R. 24.)

In its judgment order the District Court found the facts substantially as stipulated. (R. 102–

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107.) However, it added the following to the stipulated facts (R. 107–108):

> The sale of Balaban & Katz Corporation preferred stock by plaintiff during 1936 here involved was one step in, and may not be dissociated from all of the other attendant circumstances and transactions which form a part of, an elaborate plan of refinancing or recapitalization adopted and put into effect by Balaban & Katz Corporation by eliminating notes and preferred stock which bore high rates of interest, and substituting therefor a bank loan or loans carrying a much lower rate of interest, thereby increasing the net income for the payment of dividends on the common stock; the corporate structure was in no wise changed, the total assets or total capitalization were not decreased, no steps taken toward liquidating the business in any way, the only result of the transaction being to increase the net income available for the payment of dividends on the common stock.
>
> The position of Balaban & Katz Corporation as one of the leading motion picture exhibitors in the Chicago area was not changed as a result of the recapitalization plan which was put into effect during 1935 and 1936, nor were its assets, aggregate debt and stock capitalization, or operations reduced in any way by the adoption of the plan; the acquisition of preferred stock did not involve anything like a partial liquidation, nor was it in accordance with any

> bona fide plan of liquidation within the ordinary meaning of that term; apart from any question of the income tax consequence of the effect upon a statutory provision of the motive or intent of taxpayer or any other person, the transaction here involved viewed in its entirety does not come within the meaning of the term "amounts distributed in partial liquidation of a corporation" as defined in Section 115 (i) of the Revenue Act of 1936; the ultimate goal sought to be accomplished by Balaban & Katz Corporation, without giving any consideration to the intent of the parties, was not in reality a partial liquidation of that corporation but rather amounted to an expansion of the same.

The District Court concluded as a matter of law that Section 115 (c) of the Revenue Act of 1936 does not apply to a transaction which is not in effect liquidating and as a result of which there is no diminution in the assets, capitalization or operations of the corporation's business and that Section 115 (i) of the Act does not include transactions which are not in effect liquidating; hence that the redemption of its preferred stock by B & K in 1936 did not amount to a distribution in partial liquidation. (R. 108.)

The Circuit Court of Appeals reversed. (R. 126–131.) It held that the stipulated facts show that in 1936 B & K decreased its outstanding preferred stock by one-half; accordingly, that the

District Court's finding that the corporate structure was not changed and that the total capitalization was not decreased was erroneous (R. 129–130); that the cancellation and redemption of half of all the preferred stock falls within the definition of amounts distributed in partial liquidation contained in Section 115 (i) of the Revenue Act of 1936, and that the gain thereon realized by the taxpayer is therefor taxable in its entirety under the provisions of Section 115 (c) of the Act. (R. 130.)

ARGUMENT

(1) Section 115 (i) of the Revenue Act of 1936 (Appendix, *infra,* p. 25) defines the term "amounts distributed in partial liquidation," as used in Section 115, as—

> a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

There is no proof that the distribution in redemption of stock on May 1, 1936, was one of a series of distributions,[3] and consequently only the

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[3] Although the directors adopted a resolution at their meeting on February 5, 1936, that the officers should give notice to preferred stockholders of the present intention of the corporation to redeem and retire over a period of years all of the preferred stock, as set foth in the plan (R. 30), the stipulation does not show that any further distributions in redemption of the stock were made, and the certificate filed

first part of the definition is pertinent here.

As the facts set out in the Statement, *supra,* show, B & K adopted a stock redemption plan, and pursuant thereto, called in all of its outstanding preferred stock certificates, issued a new certificate to each stockholder for one-half the number of shares represented by the old certificate, retired and cancelled the other half of the shares as of May 1, 1936, distributed the amount of $110 per share and the accrued dividends thereon in payment for the shares so retired and cancelled, and was forbidden by its charter to reissue retired, redeemed, or repurchased preferred stock. The corporation, therefore, made a distribution in complete cancellation or redemption of a part of its stock, i. e., one-half of its outstanding preferred stock. Thus, the redemption transaction fits exactly within the first definition of partial liquidation in Section 115 (i) and also within Article 115–5 of Treasury Regulations 94 (Appendix, infra, pp. 26–27), pro-

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with the Secretary of State of Delaware on April 28, 1937, states that 13,055 shares of the outstanding preferred stock (one-half) only have been retired (R. 26–27). This was the amount of stock to be redeemed in 1936 in accordance with the plan. The stipulation states that pursuant to the notice of redemption B & K acquired 12,995 shares. (R. 26.) The slight discrepancy of 60 shares between the shares stated in the certificate of retirement (13,055) as having been retired and the 12,995 shares acquired pursuant to notice of redemption is not explained, but in any case it is not inferable from this small inconsistency that there was a second distribution in cancellation or redemption of stock.

viding that a complete cancellation or redemption of a part of corporate stock may be accomplished, *inter alia,* by taking up all the old shares of a particular series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata. See also *Kelly* v. *Commissioner,* 97 F. 2d 915 (C. C. A. 2d); *Malone* v. *Commissioner,* 128 F. 2d 967 (C. C. A. 5th).

As the Circuit Court of Appeals held (R. 130), the District Court's determination (R. 107–108) that the stock capitalization of B & K was not decreased and its capital structure was not changed is entirely unsupported and is contrary to the stipulated facts that one-half of the shares of preferred stock were retired and could not, under B & K's charter, be reissued, that the capital of the corporation was reduced by $1,305,500, and that the certificate of incorporation was amended to reflect these changes (R. 26–27). Indeed, the taxpayer makes no contention that one-half of the outstanding shares of preferred stock of B & K were not cancelled and redeemed completely but relies instead on the view of the District Court that a distribution in complete cancellation or redemption of a part of a corporation's stock is not a distribution in partial liquidation within the meaning of Section 115 (i), even though it complies literally with the statutory definition, unless it is accompanied by a re-

trenchment of corporate business or represents a distribution of idle corporate assets. (Pet. Br. 23–27.)

But the District Court's view of the statutory requirements was erroneous, as the Circuit Court of Appeals held. The statutory definition itself prescribes no such criteria as a curtailment or partial liquidation of corporate business. The question is not whether there was a partial liquidation in the usual or ordinary sense. 1 Mertens, Law of Federal Income Taxation, Sec. 9.83, pp. 547–548; *Salt Lake Hardware Co.* v. *Commissioner,* 27 B. T. A. 482; *Robinson* v. *Commissioner,* 42 B. T. A. 725, 735. As the Tax Court said in *Allport* v. *Commissioner,* 4 T. C. 401, 403, dismissed and affirmed January 29, 1946 (C. C. A. 7th)—

> The statute applies, not to a distribution in liquidation of the corporation or its *business,* but to a distribution in cancellation or redemption of a part of its *stock.*

Moreover, the settled construction has been that a distribution in complete cancellation or redemption of a part of corporate stock is a partial liquidation within Section 115 (i), irrespective of whether or not it is accompanied by an intent to curtail or liquidate the corporate business or any part thereof. See *Yankey* v. *Commissioner,* 151 F. 2d 650 (C. C. A. 10th); *Commissioner* v. *Quackenbos,* 78 F. 2d 156 (C. C. A. 2d); *Malone*

v. *Commissioner,* 128 F. 2d 967 (C. C. A. 5th); *Hill* v. *Commissioner,* 126 F. 2d 570 (C. C. A. 5th); *Alpers* v. *Commissioner,* 126 F. 2d 58 (C. C. A. 2d); *Amelia H. Cohen Trust* v. *Commissioner,* 121 F. 2d 689 (C. C. A. 3d); *Hammans* v. *Commissioner,* 121 F. 2d 4 (C. C. A. 2d); *Kelly* v. *Commissioner,* 97 F. 2d 915 (C. C. A. 2d); *Mittelman* v. *Commisisoner,* 5 T. C. 932, 939–940; *R. D. Merrill Co.* v. *Commissioner,* 4 T. C. 955; *Cochran* v. *Commissioner,* 4 T. C. 942, 951; *Allport* v. *Commissioner* 4 T. C. 401, 403, dismissed and affirmed January 29, 1946 (C. C. A. 7th); *Irvine* v. *Commissioner,* 46 B. T. A. 246; *Coley* v. *Commissioner,* 45 B. T. A. 405, appeal dismissed May 25, 1942 (C. C. A. 5th); *Robinson* v. *Commissioner,* 42 B. T. A. 725; *Britt* v. *Commissioner,* 40 B. T. A. 790, 795–796, affirmed on other grounds, 114 F. 2d 10 (C. C. A. 4th); *Salt Lake Hardware Co.* v. *Commissioner,* 27 B. T. A. 482; see also 1 Mertens, Law of Federal Income Taxation, Section 9.83.[4]

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[4] *Beretta* v. *Commissioner,* 141 F. 2d 452 (C. C. A. 5th), certiorari denied, 323 U. S. 720, alone contains language suggesting that an intention to liquidate the business is necessary to constitute a partial liquidation, as first defined in Section 115 (i), but since there was no complete cancellation or redemption of a part of the stock, but only a reduction in par value of all the stock in that case, there was no distribution in partial liquidation within the statutory definition in any event; hence the discussion regarding the necessity for a liquidating intent was *obiter* in that case.

(Footnote Continued on Page 15)

Section 115 (i) is not concerned with the reasons for, or the circumstances surrounding, a dis-

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Of course, an intention to liquidate the corporation is manifestly necessary, under that portion of the second definition of partial liquidation contained in Section 115 (i), to demonstrate that a distribution is one of a series of distributions in complete cancellation or redemption of all of the stock. See e. g., *Shellabarger Grain Products Co.* v. *Commissioner*, 146 F. 2d 177, 181 (C. C. A. 7th); *Rheinstrom* v. *Conner*, 125 F. 2d 790 (C. C. A. 6th), certiorari denied, 317 U. S. 654; *Tate* v. *Commissioner*, 97 F. 2d 658 (C. C. A. 8th), certiorari denied, 305 U. S. 639; *Holmby Corp.* v. *Commissioner*, 83 F. 2d 548 (C. C. A. 9th); *Canal-Commercial T. & S. Bk.* v. *Commissioner*, 63 F. 2d 619 (C. C. A. 5th), certiorari denied, 290 U. S. 628. Indeed, *Wilcox* v. *Commissioner*, 43 B. T. A. 931, affirmed, 137 F. 2d 136 (C. C. A. 9th), relied on by taxpayer (Br. 24), is a case in which it was held that a distribution was not one of a series in complete cancellation or redemption of all or a portion of stock, since there was only a reduction in par value of all the stock. The language quoted by taxpayer (Br. 24–25) from the Board's opinion was used in connection with the second definition of partial liquidation in Section 115 (i), which is not involved in the instant case. See, *supra*, pp. 10–11.

Furthermore, certain cases have made a distinction between acquisition by a corporation of its own stock for purposes of retirement, that is, complete cancellation or redemption, and acquisition to hold as treasury stock until reissued. Acquisitions of the latter type have been held not to be partial liquidations within Section 115 (i) on the theory that the corporation does not alter its capital structure by complete cancellation of stock. See, e. g., *Amelia H. Cohen Trust* v. *Commissioner*, 121 F. 2d 689 (C. C. A. 3d); *Fry* v. *Helvering*, 128 F. 2d 737 (C. C. A. 2d). This doctrine has even been extended to a case where the corporation could legally reissue the stock which it acquired and retired. *Alpers*

 (Footnote Continued on Page 16)

tribution in complete cancellation or redemption of a part of the stock.[5] Consequently, it is immaterial that the cancellation and redemption of

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v. *Commissioner*, 126 F. 2d 58 (C. C. A. 2d). Upon such a question the presence or absence of a liquidating intent may be relevant. In its opinion (R. 95–96, 97–98) the District Court relied on cases (*Hadley* v. *Commissioner*, 1 T. C. 496; *Smith* v. *Commissioner*, 38 B. T. A. 317; *Berger* v. *Commissioner*, decided January 12, 1939 (1939 C. C. H. B. T. A. Memorandum Decisions Service, par. 10, 561–E), appeal dismissed, 106 F. 2d 999 (C. C. A. 6th)), involving corporate acquisitions of treasury stock, not acquisitions for retirement and cancellation, as here. This was so also in *Harter Bank & Trust Co.* v. *Gentsch*, 60 F. Supp. 400 (N. D. Ohio), and *Trust Co. of Georgia* v. *United States*, 60 F. Supp. 470 (C. Cls.), cited by taxpayer (Br. 25, 26). The quoted statements from these cases with respect to an intention to liquidate must be read in the light of the question there under consideration.

[5] These might be pertinent, of course, if the question were whether the distribution in complete cancellation or redemption of a part of corporate stock, otherwise within Section 115 (i) and (c), was made at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend, so that Section 115 (g) (Appendix, *infra*, p. 25) would require that the distribution be treated as a taxable dividend (to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913). Cf. *Flanagan* v. *Helvering*, 116 F. 2d 937 (App. D. C.), in which it was pointed out (p. 939) that proof as to whether the corporation is a going concern or is curtailing its activities is pertinent to the question whether the distribution is in essence a dividend. Cf. also *Smith* v. *United States*, 121 F. 2d 692 (C. C. A. 3d); *Hirsch* v. *Commissioner*, 124 F. 2d 24 (C. C. A. 9th); *Vesper Co.* v. *Commissioner*, 131 F. 2d 200 (C. C. A. 8th); *Fox* v. *Harrison*, 145 F. 2d 521 (C. C. A. 7th). Section 115 (g) is not involved here, however.

one-half of the preferred stock may have been a step in a plan to substitute bank loans with a low rate of interest for B & K's obligations bearing a higher rate of interest, as the District Court found.[6] The existence of a plan, pursuant to which a cancellation and redemption of stock is made, has no special significance for purposes of Section 115 (i). Cf. *Hammans* v. *Commissioner,* 121 F. 2d 4 (C. C. A. 2d); *Irvine* v. *Commissioner,* 46 B. T. A. 246, 262. There is no suggestion here that there was a "reorganization" within the meaning of Section 112 (g) of the Revenue Act of 1936, which requires a plan as an incident thereof. As in *Malone* v. *Commissioner, supra,* p. 968, there was no reorganization but only a reduction of the corporation's capital. No conflict exists between the decision

[6] Neither the stipulation itself (R. 23–28), the minutes of the meeting of the Board of Directors of B & K, held February 5, 1936 (R. 28–30), the stock redemption plan adopted at that meeting (R. 31–42), nor any of the other exhibits (R. 42–86) contains any statement that the stock redemption plan was linked with the payment of the gold notes in 1935. On the contrary, the stipulation shows that the plan for redemption of the preferred stock which was dated January 28, 1936 (R. 31), was not adopted by the directors of B & K until February 5, 1936 (R. 28), whereas the payment of the notes was completed in 1935, prior to either date. Thus, it would seem that the District Court's finding (R. 107) that the redemption of preferred stock was one step in a plan of refinancing to eliminate notes and preferred stock which bore high rates of interest and substitute therefor bank loans carrying a much lower rate of interest is also unsupported by any evidence.

of the lower court and the cases cited by taxpayer[7] (Pet. 5; Br. 26), since those cases all involved transactions in which a corporation was entirely liquidated as an incident of a statutory reorganization. Different considerations apply in such cases. Cf. *Commissioner* v. *Estate of Bedford,* 325 U. S. 283.

The rationale of cases such as *Gregory* v. *Helvering,* 293 U. S. 465, and *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462, does not apply in this case. The definition of "amounts distributed in partial liquidation" for purposes of Section 115 is complete in itself, as has been seen. Furthermore, the stock redemption was in substance what it purported to be in form, since it had a corporate business purpose and was not undertaken solely for tax avoidance motives. Also, the corporation, having elected to use the form of a partial liquidation, as defined in Section 115 (i), is bound to accept the tax consequences thereof. Cf. *Higgins* v. *Smith,* 308 U. S. 473; *Moline Properties* v. *Commissioner,* 319 U. S. 436. Its stockholders can have no different rights with respect to the distribution than does the corporation.

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[7] *Commissioner* v. *Whitaker*, 101 F. 2d 640 (C. C. A. 1st); *Commissioner* v. *Kolb*, 100 F. 2d 920 (C. C. A. 9th); *Helvering* v. *Schoellkopf*, 100 F. 2d 415 (C. C. A. 2d); *Helvering* v. *Leary*, 93 F. 2d 826 (C. C. A. 4th); *Gutbro Holding Co.* v. *Commissioner*, 138 F. 2d 16 (C. C. A. 2d).

Since the distribution by B & K in 1936 was an amount distributed in partial liquidation as defined in Section 115 (i), the lower court correctly held that under Section 115 (c) of the Revenue Act of 1936 (Appendix, *infra*, pp. 24–25) all of the gain resulting to the taxpayer upon receipt of the distribution in redemption of part of his stock was includible in his income for 1936. The taxpayer's argument (Br. 22–23) that Section 115 (c) does not apply here because it is specifically limited to amounts distributed in partial liquidation "of a corporation", whereas Section 115 (i) deals with redemptions "of stock" is without merit. The definition of "amounts distributed in partial liquidation" in Section 115 (i) is stated to be a definition for the whole section (115). As a matter of fact, subsection (c) is the only part of Section 115 wherein the phrase "amounts distributed in partial liquidation" appears, other than in subsection (i) defining such term. It follows that the subsection (i) definition must have been designed to apply particularly to subsection (c). In no case of which we are aware, and taxpayer cites none, has it been held that Section 115 (c) does not apply to a distribution of a corporation which is an amount distributed in partial liquidation as defined in Section 115 (i). Instead, the two subsections have always been treated as related.

Finally, the view of the District Court (R. 99–102) that the legislative history of Section 115 (c) and (i) supports its theory that the gain on a distribution in partial liquidation was to be put on a capital gain basis and treated as a sale includible in income as provided in Section 117 (a) (Appendix, *infra,* pp. 25–26), instead of being included in its entirety in income as provided in Section 115 (c), was rejected in *Amelia H. Cohen Trust* v. *Commissioner,* 121 F. 2d 689, 691 (C. C. A. 3d). Accord: *Jones* v. *Commissioner,* 4 T. C. 854.

(2) In reversing the judgment of the District Court, the Circuit Court of Appeals did not abuse its power of review. The District Court erroneously thought that Section 115 (i) contemplated an intention to curtail or liquidate the corporate business, in addition to the express requirements stated therein (R. 90–102, 108), and it based its conclusion of law (R. 108) that the redemption of the preferred stock by B & K in 1936 did not amount to a distribution in partial liquidation within the statutory definition upon its erroneous understanding of what the statute contemplated. The Circuit Court of Appeals clearly had power to correct this erroneous interpretation of the controlling statute. This would be so even if the case

ad come from the Tax Court[8] (*Trust of Bingham* . *Commissioner*, 325 U. S. 365; *Dobson* v. *Commis-ioner*, 320 U. S. 489, 492–493, 502–503; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; cf. *Commissioner* v. *Heininger*, 320 U. S. 467; *Commissioner* v. *Wilcox*, decided by this Court February 25, 1946 (No. 163), and is certainly no less so where the appeal is from a judgment of the District Court. See *Merrill* v. *Fahs*, 324 U. S. 308, 310; *Dobson* v. *Commissioner*, *supra*, pp. 495, 498–499; *Kohnstamm* v. *Pedrick* (C. C. A. 2d), decided December 28, 1945 (1946 P-H, par. 72,324). Thus, it is unnecessary in this case for the Court to decide whether the power of appellate review is greater in an appeal from the District Court than in an appeal from the Tax

[8] The conclusion that a distribution is or is not one in partial liquidation within the first definition of Section 115 (i) has heretofore been treated as reviewable. See *Malone* v. *Commissioner*, 128 F. 2d 967 (C. C. A. 5th); *Alpers* v. *Commissioner*, 126 F. 2d 58 (C. C. A. 2d); *Amelia H. Cohen Trust* v. *Commissioner*, 121 F. 2d 689 (C. C. A. 3d); *Kelly* v. *Commissioner*, 97 F. 2d 915 (C. C. A. 2d). But in any case such a question must be reviewable where, as here, the trier of the facts had an erroneous view of the statutory standard to be applied to the facts. Cf. *Trust of Bingham* v. *Commissioner*, *supra*; *Malone* v. *Commissioner*, *supra*; *Kelly* v. *Commissioner*, *supra*.

Court.[9] In either type of appeal findings of fact by the trial court should be sustained on appeal, if supported by substantial evidence. But it does not follow that an appellate court is bound by a conclusion based on a misconception of the requirements of the controlling statute. Thus, *Blumenthal Print Works* v. *United States,* 141 F. 2d 211 (C. C. A. 5th), which holds only that a finding of the trial court supported by substantial evidence will not be overturned on appeal, is not in conflict with the decision below, as taxpayer asserts it is. (Pet. 4; Br. 19.)

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[9] Section 128 of the Judicial Code (Appendix, *infra*, pp. 27–28) gives a Circuit Court of Appeals broad jurisdiction to review by appeal final decisions of District Courts, but Rule 52 (a) of the Federal Rules of Civil Procedure (Appendix, *infra*, p. 28) states that findings of fact are not to be set aside unless clearly erroneous. On the other hand, a Circuit Court of Appeals may modify or reverse a decision of the Tax Court if it is not in accordance with law. Section 1141 (c) (1) of the Internal Revenue Code (Appendix, *infra*, p. 26). This Court has observed the distinction between the scope of review in the two types of appeal (*Dobson* v. *Commissioner*, *supra*, pp. 495, 497–499; cf. *Merrill* v. *Fahs*, *supra*, p. 310) and indeed seems to have accorded a broader appellate review in tax cases arising in the District Courts than in those coming from the Tax Court (cf. *Wisconsin Gas Co.* v. *United States*, 322 U. S. 526; *City Bank Co.* v. *McGowan*, 323 U. S. 594; *United States* v. *Seattle Bank*, 321 U. S. 583). See also *Kohnstamm* v. *Pedrick*, *supra*.

CONCLUSION

The judgment of the lower court is correct and is not in conflict with any decision, either on the merits or with respect to the scope of review. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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APRIL 1946.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117 (a), 100 per centum of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution

within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

* * * * *

Internal Revenue Code:

SEC. 1141. COURTS OF REVIEW.

* * * * *

(c) *Powers.*—

(1) *To affirm, modify, or reverse.*—Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require.

* * * * *

(26 U. S. C. 1940 ed., Sec. 1141.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 115–5. *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111–1,

by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

* * * * *

In the case of amounts distributed in partial liquidation of a corporation, the amount of the loss so recognized is subject to the limitations contained in section 117 but the entire amount of the gain so recognized shall be taken into account in computing net income despite the provisions of section 117. The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

* * * * *

Judicial Code:

SEC. 128. (a) The circuit courts of appeal shall have appellate jurisdiction to review by appeal final decisions—

First. In the district courts, in all cases save where a direct review of the decision may be had in the Supreme Court under section 238.

* * * * *

(28 U. S. C. 1940 ed., Sec. 225.)

Federal Rules of Civil Procedure:

RULE 52. *Findings by the Court.*

(a) *Effect.*—In all actions tried upon the facts without a jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court.

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